

**MINUTES OF THE MEETING OF THE
TREASURY BORROWING ADVISORY COMMITTEE
OF THE BOND MARKET ASSOCIATION
February 3, 2004**

The Committee convened in closed session at the Hay-Adams Hotel at 11:35 a.m. The following members of the Committee were not present: Thomas Marsico and Richard Davis. Deputy Assistant Secretary for Federal Finance Timothy Bitsberger welcomed the Committee.

The Committee first discussed the sensitivity of Treasury's financing needs due to macroeconomic variables including GDP, inflation and interest rates, the first issue on the Committee's charge (attached). Mr. Bitsberger presented charts (attached) that depicted the long-run deficit projections of the Office of Management and Budget (OMB) and Treasury's residual financing needs based on these projections. Mr. Bitsberger pointed out that Treasury is well positioned to meet its borrowing needs with its current issuance calendar if OMB's deficit forecasts are met. Mr. Bitsberger also presented several charts showing the impact of changes in real GDP growth, inflation and interest rates on deficits as estimated by the OMB. One chart highlighted the projected increase in deficits in the out years from both a 1% decrease in real GDP growth in 2004 and a 1% decrease in real GDP growth every year through 2009. A second chart showed the impact on the projected deficit of a 1% increase in inflation and interest rates. One member observed that over the 5 year horizon, inflation has a greater absolute impact on the projected deficit.

One member noted that GDP growth is critical in determining deficits and Treasury's longer term financing needs, but that there was a lot of uncertainty over the next six to nine months. This generated discussion about tax refunds in the current fiscal year, with one member asking if the models depicted in the charts accounted for uncertainties such as spending that was announced but not implemented and the level of tax refunds this year. One member asked whether the risks Treasury faces are asymmetrical, while another member argued that they are symmetrical. One member suggested that Treasury, at a later time, give a presentation that better defines the explanatory variables discussed in the previous charts and their statistical impact. Mr. Bitsberger asked the Committee to discuss what further work Treasury should be undertaking to define and analyze some of the risks already discussed. In general, the Committee agreed with Mr. Bitsberger's statement that Treasury's issuance calendar is sufficient to meet the government's forecasted borrowing needs. One member commented that maximum flexibility was necessary and that the current calendar provided such flexibility.

The Committee next turned to the second question on the charge dealing with what criteria Treasury should use to assess its overall portfolio, balancing short and long-term issuance as well as nominal and Treasury inflation-protected securities (TIPS) issuance. Before the Committee discussed the issue, Mr. Bitsberger presented charts showing Treasury's percentage breakdown of annual issuance across maturities and distribution of marketable debt. Mr. Bitsberger also presented a chart showing that a small amount of long-term debt as a percent of total issuance can result in a larger percentage of the total portfolio held in long-term debt. Several members discussed the point that setting TIPS as a fixed percentage of the portfolio (either in nominal terms or as a percent of issuance) could be inflexible. One member suggested looking at cash flows, noting the difference between TIPS, nominal coupons and bills in this

regard. One way to look at the portfolio would be to determine how much of each type of cash flow Treasury would want. One member suggested setting a ceiling on bill issuance as a percentage of annual issuance, a floor for issuance between 2-3 years, and a target for long-term issuance, with the residual in TIPS. One member asked if Treasury should also look at how to manage its assets and not just liabilities.

Mr. Bitsberger then presented several charts showing demand for TIPS, highlighting some of the different investor demand at auction between TIPS and nominal securities and increasing demand from public pension funds. The Committee agreed that there is a growing demand for TIPS as a separate asset class. However, several members cautioned against overstating the point that the distribution of TIPS auction awards demonstrated a unique demand for the product. They noted that because TIPS are less liquid, investors who want to own them must buy at auction rather than in the secondary market, and that the auction data may show market segmentation, with investors buying nominal securities for liquidity purposes and TIPS for investment purposes.

Mr. Bitsberger then presented a chart showing the sensitivity of the real value of longer-term liabilities to changes in inflation. The chart highlighted that TIPS reduce the potential variability of the real value of Treasury's debt liabilities. The discussion then turned back to the question of what criteria Treasury should use to assess its overall portfolio. One member expressed concern that Treasury was not taking the level of interest rates into account when thinking about this issue. Another member noted that in thinking about issuing more TIPS, Treasury is correctly trying to identify new demand and take advantage of that demand and broaden the investor base. Another member reiterated that flexibility is an important criteria for Treasury.

Mr. Bitsberger asked the Committee where Treasury should decrease issuance if they introduce a new TIPS maturity point, assuming borrowing is held at its current level. The Committee was somewhat divided on the response. One member suggested that Treasury should first look at the reasons for a smaller-than-expected deficit, and that the first place to reduce issuance would be in the bill sector if the reasons are of a more temporary nature. Several members agreed with this assessment and one member recommended Treasury do more analysis comparing the cost of bill issuance versus TIPS issuance. However, other members thought that the first place to reduce issuance would be in the 10- or 5-year sectors of the nominal curve. One member sighted the decrease in flexibility if Treasury adds a 20-year TIPS, and suggested that it would be logical to cut back on longer-dated nominal issuance which is also more inflexible for Treasury. Another member thought that Treasury should place some importance on the level of interest rates when determining the best sector in which to reduce issuance.

The Committee then discussed the third question on the charge dealing with the November refunding calendar and auction schedule, which is complicated by several potential market-moving events and a holiday. Mr. Bitsberger presented three options for the refunding auction schedule. The Committee said they would take the options under consideration, and would look into possibly changing the scheduled meeting date for the Committee in November.

The meeting adjourned at 1:03 p.m.

The committee reconvened at 3:05 p.m. and finalized its recommendation for borrowing in this quarter and the April June quarter. Those charts are attached.

The committee made a presentation on Foreign Central bank purchases of Treasury securities.

First, Bruce Kasman of JP Morgan made a presentation that macro economic conditions in both Asia and the US over the last several years resulted in a situation where the Asian governments have attempted to devalue their currencies and the Federal reserve has been on hold. This low US rate, low Asian currency relationship was good policy and beneficial to the economies in both regions for a period of time. There are perceptions that it can continue indefinitely. However, economic fundamentals are changing with both Asia and the US experiencing growth and government policies of keeping US rates low and Asian currencies weak are artificial and do not match current macro economic conditions. Mr. Kasman estimates that foreign central bank purchases are actually depressing yields in the 2 to 3 year note sector by 60 to 80 basis points. He argues that the longer these policy positions ignore the macroeconomic fundamentals, the greater and potentially more disruptive a return to equilibrium will be. He saw 3 catalysts for such a disruption. These include the potential of Asian governments to control currency appreciation despite significant intervention activity, inflation in the US economy, and a pandemic such as SARS or avian flu through-out Asia.

Next, economist Mickey Levy of Bank of America made a presentation suggesting that trade imbalances reflect economic fundamentals, but are not inherently economically “bad” nor do they portend future bad economic news. Fundamentally, the current account deficits reflect the attractiveness of US assets. Furthermore, empirical evidence suggests that large current account deficits have little impact on interest rates or foreign exchange rates. Interest rates are a function of real economic growth, inflation expectations, and Fed policy. Foreign central banks have been purchasing US Treasuries and other US fixed income assets for policy reasons that are not necessarily related to these three reasons that drive interest rates. Mr. Levy thinks that there are no current catalysts on the horizon to change foreign central bank policy.

The meeting adjourned at 4:15 p.m.

The Committee reconvened at the Hay-Adams Hotel at 5:35 p.m. The following members of the Committee were not present: Thomas Marsico and Richard Davis. The Chairman presented the Committee report to the Acting Under Secretary for Domestic Finance, Brian Roseboro and Deputy Assistant Secretary for Federal Finance, Tim Bitsberger. A brief discussion followed the Chairman's presentation but did not raise significant questions regarding the report's content.

The meeting adjourned at 6:00 p.m.

Jeff Huther
Director
Office of Debt Management
February 3, 2004

Certified by:

Mark B. Werner, Chairman
Treasury Borrowing Advisory Committee
of The Bond Market Association
February 3, 2004

**Treasury Borrowing Advisory Committee Quarterly Meeting
Committee Charge**

Sensitivity of Financing Needs to GDP Estimates

We showed some of the financing risk associated with proposed or potential legislation at the last Committee meeting. We will now show the Committee slides on the uncertainty of our financing needs due to macroeconomic variables including real GDP, inflation and interest rates. Given this sensitivity and the central forecast of our borrowing needs, we would like the Committee's advice on whether Treasury's financing calendar provides sufficient flexibility.

Treasury Inflation-Protected Securities

We believe our current issuance calendar can meet the government's projected financing needs. We are also committed to further growing the TIPS market. We would like the Committee's advice on what criteria to use to assess our overall portfolio composition, keeping in mind our need to balance short and long term issuance as well as both nominal and TIPS issuance.

Changes to Auction Calendar

The November refunding calendar is complicated by several potential market-moving events and Veterans Day. We would like the Committee's advice on the scheduling of auctions in the final quarter of this year.

Financing this Quarter

We would like the Committee's advice on the following:

- The composition of Treasury notes to refund approximately \$26.6 billion of privately held notes and bonds maturing on February 15.
- The composition of Treasury marketable financing for the remainder of the January – March quarter, including cash management bills.
- The composition of Treasury marketable financing for the April – June quarter.

Other Issues

Are there other issues relating to the current state of the Treasury market that the Committee would like to bring to Treasury's attention?